

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:) OTA Case No. 20056173
G. SCHOLLER AND)
S. SCHOLLER)
_____)

OPINION ON PETITION FOR REHEARING

Representing the Parties:

For Appellants: Mauro P. Colabianchi, Attorney
For Respondent: Brad J. Coutinho, Attorney Supervisor

A. VASSIGH, Administrative Law Judge: On April 23, 2025, the Office of Tax Appeals (OTA) issued an Opinion sustaining the action of respondent Franchise Tax Board (FTB) proposing additional tax of \$100,203, an accuracy-related penalty of \$20,040.60, and applicable interest, for the 2003 tax year. In the Opinion, OTA held appellants were not entitled to a bad debt deduction for the 2003 tax year; nor were appellants entitled to a worthless stock deduction for the 2003 tax year in relation to funds transferred to N'Lightning Software Development, Inc. (the Company). The Opinion also held that the accuracy-related penalty should be abated and that interest could not be abated.

On May 23, 2025, appellants timely filed a petition for rehearing (petition) with OTA under Revenue and Taxation Code (R&TC) section 19048 on the basis that an irregularity in the appeal proceedings occurred prior to the issuance of the Opinion and prevented fair consideration of the appeal, and that OTA's Opinion is contrary to law and unsupported by sufficient evidence. Upon consideration of appellants' petition, OTA concludes that the grounds set forth in this petition do not constitute a basis for granting a new hearing.

OTA will grant a rehearing where one of the following grounds for a rehearing exists and materially affects the substantial rights of the party seeking a rehearing: (1) an irregularity in the appeal proceedings which occurred prior to issuance of the Opinion and prevented fair consideration of the appeal; (2) an accident or surprise, occurring during the appeal proceedings and prior to the issuance of the Opinion, which ordinary caution could not have

prevented; (3) newly discovered evidence, material to the appeal, which the party could not have reasonably discovered and provided prior to issuance of the Opinion; (4) insufficient evidence to justify the Opinion; (5) the Opinion is contrary to law; or (6) an error in law in the OTA appeals hearing or proceeding. (Cal. Code Regs., tit. 18, § 30604(a)(1)-(6); *Appeal of Shanahan*, 2024-OTA-040P.)

Irregularity in the Appeal Proceeding

An irregularity in the proceedings warranting a rehearing would generally include any departure by OTA from the due and orderly method of conducting appeal proceedings by which the substantial rights of a party (here, appellants) have been materially affected. (*Appeal of Graham and Smith*, 2018-OTA-154P; see also *Jacoby v. Feldman* (1978) 81 Cal.App.3d 432, 446.) Indeed, courts have found that an irregularity in the proceeding is “any act that (1) violates the right of a party to a fair trial and (2) which a party ‘cannot fully present by exceptions taken during the progress of the trial’ [citation].” (*Montoya v. Barragan* (2013) 220 Cal.App.4th 1215, 1230.) Included in the classification of irregularities is an “overt act of the trial court . . . or adverse party, violative of the right to a fair and impartial trial” (*Russell v. Dopp* (1995) 36 Cal.App.4th 765, 780.) Examples of irregularities include the absence of a judge from the courtroom during a portion of the trial, and a judge threatening to prejudge testimony unless a witness is withdrawn. (See *O’Callaghan v. Bode* (1890) 84 Cal. 489, 495; see also *Pratt v. Pratt* (1903) 141 Cal. 247, 252.)

Appellants argue that OTA’s March 4, 2025 Orders excluding their late-submitted exhibits from admittance into the evidentiary record of this appeal constitute an irregularity in the appeal proceeding which prevented fair consideration of the appeal. OTA issued Minutes and Orders to the parties before the hearing, stating that any additional exhibits must be submitted 15 days in advance of the hearing. On September 25, 2024, two days prior to the hearing that was held on September 27, 2024, appellants submitted additional exhibits labelled 15 through 18. FTB objected to the admission of appellants’ late exhibits. Following the hearing, the record was held open to allow each party to file an additional brief to discuss, among other matters, the admissibility of the late exhibits. On November 8, 2024, and January 17, 2025, appellants submitted additional briefs which addressed, among other matters, the admissibility of the late exhibits. On March 4, 2025, OTA issued Orders excluding appellants’ late-submitted exhibits labelled 17 and 18, which were marked for identification, and overruling FTB’s objection to exhibits 15 and 16. Exhibits 15 and 16 were then admitted and entered into the record.

Parties may submit late exhibits upon a showing of good cause. (Cal. Code Regs., tit. 18, § 30420(a).) All evidence that is relevant shall be admissible. (Cal. Code Regs., tit. 18, § 30214(f)(1).) OTA's Panel Members may rule on the receipt of relevant and material evidence. (Cal. Code Regs., tit. 18, § 30213(a)(1).) Further, the lead Panel Member has discretion to exclude evidence upon determining that its probative value is substantially outweighed by the probability that its admission will necessitate undue consumption of time. (Cal. Code Regs., tit. 18, § 30214(f)(3).)

In this case, OTA determined that appellants showed good cause for the late submission of the Exhibits 15 and 16, and admitted Exhibits 15 and 16 into the record. OTA did not allow Exhibits 17 and 18 into the record. It is this exclusion of the late-submitted documents upon which appellants base their argument.

As will be explained below, neither of these exhibits were probative of appellants' argument, and allowing them into the record for further analysis would have necessitated an undue consumption of time. OTA determined that appellants had not shown that Exhibits 17 and 18, which are financial documents of the Company, were relevant either to the questions of appellants' expectations of repayment or, assuming the advances were loans, whether and when they might have become worthless debt.¹ Exhibits 17 and 18 were not relevant to appellant's argument regarding the worthlessness of stock, either, as these documents did not demonstrate the fair market value of the Company's assets at the time of alleged worthlessness and did not establish the value of assets (liquidated or otherwise) at that time.

As discussed below, this OTA Panel has reviewed the excluded exhibits and concluded that the inclusion of these exhibits into the record would not have changed OTA's analysis or holding. OTA appropriately exercised its discretion in excluding Exhibits 17 and 18 from the evidentiary record, and this did not constitute an irregularity in the appeal proceedings which prevented fair consideration of the appeal. The record shows that appellants were provided the opportunity to address the admissibility of the exhibits, and in fact did so in their additional briefs filed November 8, 2024, and January 17, 2025. A rehearing is not warranted on this basis.

Insufficient Evidence

To find that there is insufficient evidence to justify the Opinion, OTA must find that after weighing the evidence in the record, including reasonable inferences based on that evidence, OTA clearly should have reached a different opinion. (*Appeal of Swat-Fame Inc., et al.*, 2020-

¹ The exhibit cover pages state that the balance sheet and the profit-and-loss statement are "from December 2022." Appellants' PFR also refers to "the end of 2022" (pages 3 and 5). OTA assumes this is a typo and that appellants intention is to refer to 2002 in each of these instances.

OTA-045P.) OTA considers the evidence in the light most favorable to the prevailing party (which in this matter is FTB). (*Ibid.*)

The burden was on appellants to prove they were entitled to the claimed deduction. (*INDOPCO, Inc. v. Commissioner* (1992) 503 U.S. 79, 84; *Appeal of Dandridge*, 2019-OTA-458P.) The taxpayer bears the burden of proof on the questions of whether shares of stock become worthless, and the taxable year in which such worthlessness occurred. (*Austin Co., Inc. v. Commissioner* (1979) 71 T.C. 955, 969-970; *Delk v. Commissioner* (9th Cir. 1997) 113 F.3d 984, 986.) As stated in the Opinion, based upon the evidence, the advances were indicative of capital contributions and were not bona fide debt. Appellants did not meet their burden of proof to establish that their stock in the Company was worthless. Exhibits 17 and 18 do not advance appellants' argument; even if OTA had admitted the exhibits into the record, the analysis and holding in the Opinion would have remained the same.

In their petition for rehearing, appellants state that Exhibit 17 "is likely one of the final Balance Sheets produced by the Company." A review of Exhibit 17 makes clear it is not the final balance sheet – a final balance sheet would reflect that the Company had liquidated all assets and paid off its liabilities, effectively ceasing operations. Exhibit 17 shows that in December 2002, the Company still had assets (including inventory valued at over \$138,000) and owed liabilities. This snapshot in time does not give a clear accounting of the Company's worth and therefore does not advance appellants' arguments, rendering it irrelevant. Therefore, Exhibit 17 was properly excluded from the evidentiary record.

Exhibit 18 is a profit-and-loss statement from December 2002, and shows that the Company was still operating and had some sales. Though OTA was not provided profit-and-loss statements to compare other years to December 2022, it is apparent from the testimony at the hearing that the Company was operating at a lower capacity than previously. However, appellants did not establish that their stock in the Company was worthless. As OTA stated in its Opinion, "The value of the stock was significantly impaired, but it is unclear whether it had no liquidating value and OTA cannot speculate as to the actual liquidating value of the Company." Thus, appellants did not provide sufficient evidence to prove that the stock was worthless in the year at issue here. This remains unchanged by Exhibit 18, which shows that the Company was still operating and had value.

Appellants' arguments do not persuade OTA that the Opinion should have reached a different conclusion. (See *Appeals of Swat-Fame, Inc., et al., supra.*) This OTA Panel has reappraised the evidentiary record as well as the excluded exhibits, and finds that the evidence supports OTA's Opinion.

Contrary to Law

The “contrary to law” standard of review shall involve a review of the Opinion for consistency with the law. (Cal. Code Regs., tit. 18, § 30604(b).) The question of whether a decision is contrary to law is not one that involves a weighing of the evidence but instead requires a finding that the decision is “unsupported by any substantial evidence.” (*Appeals of Swat-Fame, Inc., et al., supra.*) This requires indulging “in all legitimate and reasonable inferences” to uphold the Opinion. (*Ibid*, citing *Sanchez-Corea v. Bank of America* (1985) 38 Cal.3d 892, 907.) The relevant question is not over the quality or nature of the reasoning behind the Opinion, but whether the Opinion can or cannot be valid according to the law. (*Appeals of Swat-Fame, Inc., et al., supra*, citing *Appeal of NASSCO Holdings, Inc.* (2010-SBE-001) 2010 WL 5626976.) A rehearing may be granted when, examining the evidence in the light most favorable to the prevailing party (here, FTB), with all legitimate inferences to uphold the Opinion, the petitioning party (here, appellants) establish that the Opinion incorrectly stated or applied the law and, therefore, is contrary to law. (*Appeal of NASSCO Holdings, Inc., supra*, at p. *5.)

In the petition, appellants contend that showing a lack of liquidating value is not the standard for worthlessness, and point out that “the courts have not interpreted the standard of worthlessness so strictly as to include the recovery of nominal amounts.” However, in order for the taxpayer to be entitled to income tax deduction for a loss from a worthless security, the taxpayer must satisfy a two-pronged test, by demonstrating: (1) that the stock has no current liquidating value; and (2) that the stock has no potential future value. (IRC, § 165(g)²; *Delk v. Commissioner, supra.*) The Opinion made clear that appellants did not meet their burden to establish worthlessness, explaining that “OTA cannot determine whether the Company ceased to have liquidating value (assets over liabilities).” During 2003, the Company had assets, the value of which would be available as liquidating value to appellants. Appellants argue in their PFR that the assets were essentially worthless. However, appellants failed to establish that the assets only had trivial value, including whether the remaining amount of inventory or office equipment could have been sold, or whether there were intangible rights to the games.


Appellants’ claim that any attempt to search for a hypothetical buyer of inventory or rights to software would have been met “with a next-to-zero chance of success” is merely an unsupported statement. Citing to *Buchanan v. U. S.* (7th Cir. 1996) 87 F.3d 197 (*Buchanan*), appellants conclude that “recovery of a trivial fraction of the debt which did not cover the cost of

² California conforms to IRC section 165(g) pursuant to R&TC section 17201.


collection would still be consistent with deemed worthlessness in the year the worthless security was written off.” But this analysis is only applicable to nonbusiness bad debt under IRC section 166(a). Appellants incorrectly apply *Buchanan* in their discussion of a worthless stock deduction, which falls under IRC section 165(g)(1). Regardless, appellants did not attempt such a recovery and are asking OTA to speculate as the results of a recovery effort that did not take place.


Further, as the Opinion explained, if a company’s assets are less than its liabilities but there is a “reasonable hope and expectation” that the assets will exceed the liabilities of the company in the future, then the company’s stock, while having no liquidating value, has potential value and cannot be said to be worthless. (*Morton v. Commissioner* (1938) 38 B.T.A. 1270, 1278-1279, *affd.* (7th Cir. 1940) 112 F.2d 320; see also *Bilthouse v. U.S.* (7th Cir. 2009) 553 F.3d 513, 515.) While appellants established that the value of the stock was significantly impaired in 2003, they did not demonstrate the fair market value of the Company’s assets at the time of alleged worthlessness and did not establish the value of assets (liquidated or otherwise) or rights to software. As explained in the Opinion, OTA could not determine whether (nor when) the Company ceased to have liquidating value. Thus, appellants have not established that the Opinion is contrary to law.

Accordingly, OTA finds that appellants have not established that a ground exists for a rehearing. Appellants’ petition for rehearing is denied.

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Amanda Vassigh
Administrative Law Judge

We concur:

Signed by:

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Veronica I. Long
Administrative Law Judge

Signed by:

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Seth Elsom
Hearing Officer

Date Issued: 1/28/2026